2017: SECOND QUARTER

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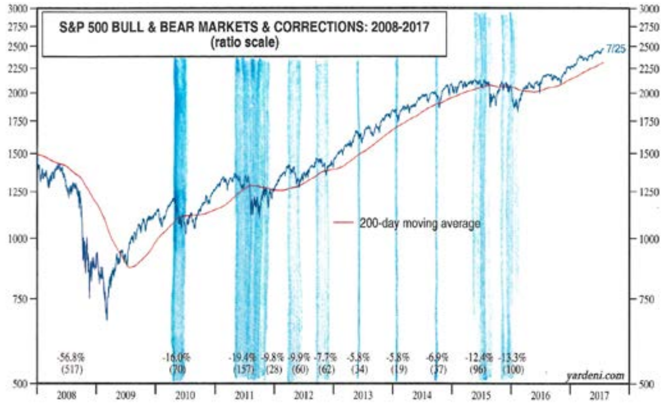
"The surest test of discipline is its absence."
Clara Barton

On February 9, 2016, and again on March 8, 2016, we advocated a steady hand in the face of extraordinarily weak markets. We remained committed to our equity allocations and used the weakness to upgrade the quality of our underlying holdings. We were able to move boldly and with confidence because we employ rigorous, time-proven valuation disciplines that provide confidence to take appropriate action in difficult markets like then and…now. Whether during a sell-off or melt-up in stock prices, discipline is paramount.

Through 6/30/2017 the S&P 500 is up 9.34% and the current bull market is measured as the second longest bull market on record. The longest began on 12/4/1987 and ran 4,494 days ending officially on 3/24/2000. During that time stocks rose 582.15%. This Bull is a little tamer returning 266.5% since it began on 3/9/2009, and through 7/26/2017, has lasted for 3,061 days. History would argue the Bull could very well still have legs. But the naysayers are beginning to raise the notion that stock valuations have moved well ahead of earnings growth and that multiples are stretched, begging the question: is the bear lurking around the corner?



Note: Corrections are declines of 10% or more, while minor ones are 5%-10% (all in blue shades). Bear markets are declines of 20% or more (in red shades). Number of calendar days in parentheses.
Source: Standard & Poor's.
Yardeni Research, Inc.
www.yardeni.com

To be sure, we would welcome a correction (not to be confused with a bear market). It has been over a year since we have had a meaningful pullback in stock prices. Corrections serve as a pruning mechanism, clearing out the rubble and making way for new growth. They provide an opportunity for those who have been sitting on the sidelines, to enter the game, putting fresh money to work. That action tends to power stocks higher. And corrections normalize valuations, which also provide a catalyst for further moves up.

Our Performance: Heartland Financial, USA, Inc. and its member banks offer ten core investment strategies. Year-to-date and in calendar year 2016, eight of our ten strategies outperformed their (industry standard) benchmarks. When compared to peer groups of like managers, all of the strategies rank among the top percentiles of their peer groups nationwide. Employing time-proven disciplines provides conviction to buy securities at attractive valuations, execute prudent interest rate decisions and select high-quality subadvisors. When discipline is present, performance follows. It is the absence of discipline that ensures volatility and underperformance. (Please contact your wealth advisor to view our investment returns by strategy.)

The Environment: Stocks logged in another strong performance during Q2. The S&P 500 returned 3.09%, the Dow Jones Industrial Average logged in 3.95% and the NASDAQ powered ahead 4.21% as technology provided investors with growth (and income) in a slow-growth environment. Earnings and revenue growth have pleasantly surprised to the upside year-to-date—we expect to finish the quarter with the S&P companies

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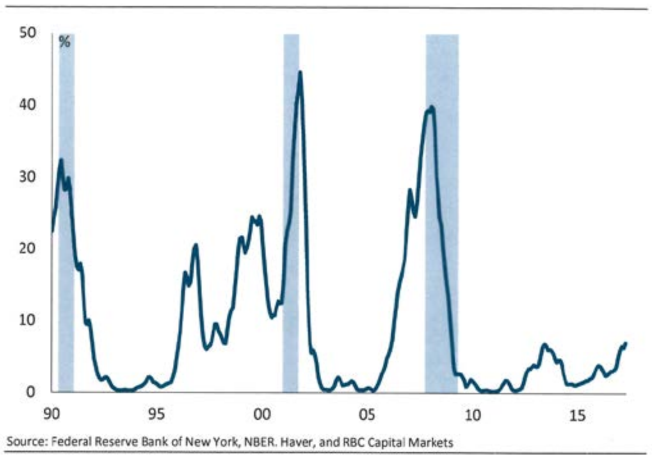
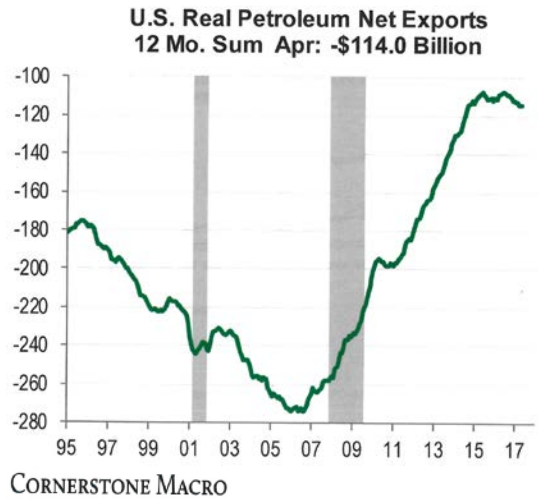
growing in the low double-digits. Not too shabby given the slow (but steady) growth in GDP. Since the election this market has been characterized by rotation from one sector to another. And that rotation has driven the overall market higher as investors took advantage of relatively attractive opportunities in underlying industries like financials, then pharmaceuticals, biotech, aerospace and defense, internet software and services and (believe it or not!) multi-line retail.

With each tick up in the indices and without a proper correction under our belts, these past 16 months the drumbeat for a correction or even a bear market sell-off has increased significantly. But the end to a bull market is usually accompanied by euphoric buying (we have seen none of that) and/or recession. The New York Fed puts the probability of a correction at under 10% - hardly a threat to near-term stock returns.

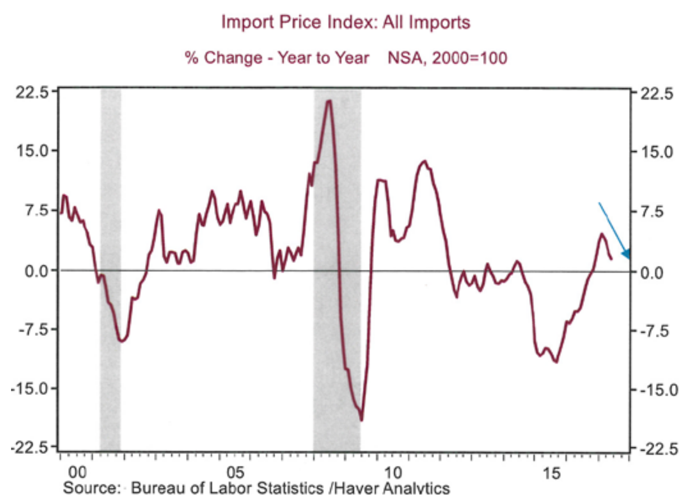


With second quarter GDP just reported at a positive 2.6% and the first quarter revised down to up 1.2% (versus the initial report of 1.4%) we see the economy chugging along in that not-too-hot-not-too-cold fashion that equity investors love. The Fed is being restrained by lower than expected inflation (see Paul Dickson's brilliant fixed income and interest rate commentary following), add a weak dollar (which benefits multi-national corporations like the ones we own in our large-cap equity portfolios), and tame oil prices and we foresee an environment that is still pretty friendly to stocks.

The bear may be lurking but he is not around the corner.



It should be noted the U.S. has become the marginal producer of oil globally and thanks to the innovation of U.S. energy producers, our petroleum trade balance has improved by $160B over the last decade. Even more interesting, according to our friends at Cornerstone Macro, during the first five months of 2017, the U.S. exported oil to China at the pace of nearly 100,000 barrels per day—10 times the average in 2016. Muted oil prices are here to stay in the medium term and that is good for the consumer, which is good for economic growth.



Though we are mindful of the many risks present for equity investors, we take solace in the fact that a significant amount of investors remain on the sidelines waiting for an opportunity to become more fully invested in stocks—as some have said: this is the most unloved bull market in history. As already mentioned, the typical euphoria that precedes the end of a bull market run is absent. The consumer is in excellent shape, and though personal debt levels have been rising, they are well off 2008 levels. We are confident that the consumer will remain healthy and spending. Additionally, the age of corporate fixed assets has reached levels not seen since 1965. Capex as a percent of industrial company sales is about 20% below the historical average of the last 20 years. Both of these statistics bode well for spending and potential improvements in productivity—both good for GDP growth. Overshadowing all of this is the giant elephant in the room…can this Administration get tax reform, or at the very least, tax cuts done before the end of the year? The market is assuming not, so any movement in that direction is like to cause stocks to rally from current levels.

International Markets: Our international sub-advisor, Alliance Bernstein has produced outstanding performance since inception on February 1. Through June 30 our international composite is up 14.1% compared to the MSCI EAFE which returned 10.6%--a significant premium to the market.

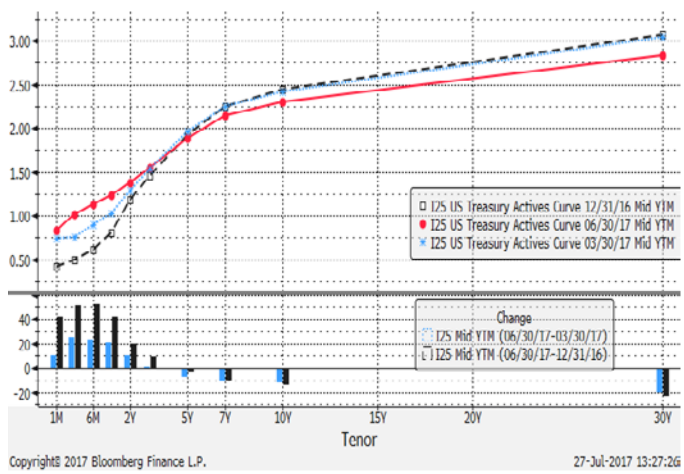
There has been no material escalation in political risk over the quarter (globally). In fact, we view that there have been upgrades to Eurozone and China growth. In Europe, the tide of populism came to an end, at least for this year, as President Emmanuel Macron swept to power in France. His pro-Europe agenda and promise to begin a program of pro-growth secular reform will be taken very positively by investors, if he is seen to be making any headway. Of course, we have heard this before in France so some skepticism is warranted, but the early signs are positive. The outlier in Europe, while it is still included in Europe, is the UK, where the outcome of Brexit has become even more uncertain following Theresa May's ill-timed call for an election, where she lost her majority in parliament and will now try to govern with the support of the Ulster Unionists. This uncertainty is likely to weigh on UK growth, as companies are unlikely to invest until they understand the full consequences of Brexit. In Asia, Chinese growth has been revised upwards modestly, and for the time being the country seems to have stabilized growth at around 6%. This is an outcome that both investors and politicians seem comfortable with, so we would not expect any major changes to policy, unless that growth begins to weaken.

Our allocation to international markets currently sits at 15%.

FIXED INCOME Q2 2017

The Environment: In the second quarter of the year the fixed income markets were largely calm with a bias towards lower long-term rates as the market increasingly discounted both future inflation as well as the Federal Reserve's increasingly hawkish stance. The U.S. Treasury Yield Curve flattened with long rates falling and short rates being forced up by Fed policy action. That Fed action included a second short term rate hike this year (in June) and the announcement of plans to begin selling off the bonds purchased during the various "quantitative easing (QE)" periods since the Great Recession. During those QE efforts, the Fed purchased $4.5 trillion in U.S. Treasury and Mortgage-Backed securities in an effort to push down long-term interest rates and spur economic growth. The Fed now plans to unwind those trades.

Evolution of the U.S. Treasury Yield Curve in 2017 by Quarter



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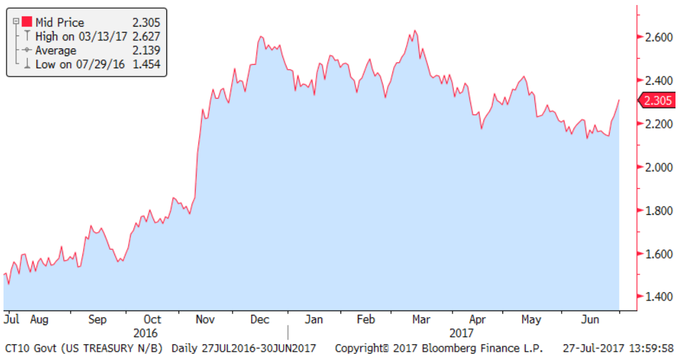
Given the most recent rate hike, rates on the short end are now anchored at or above 1% beyond 3 months, as one would expect. Longer-term rates are more of a puzzle: In spite of announcing that the Fed will begin selling off its stockpile of securities, longer-term rates fell rather than rose as expected. More specifically, in terms of the Treasury curve, the yield on the bellwether 10-year U.S. Treasury bond fell nearly 10 bps from 2.4% in March to 2.3% at the end of June after a 25 bp hike in the Fed Funds rate. The 30-year Long Bond rate fell nearly 20 bps from just over 3.0% to 2.8%. While the long-end of the curve fell, the very short end saw a rise: the 3-month T-Bill rose from 0.75% to 1.0% on an annual basis, reflecting policy.

US Treasury 10-Year, Yield



While it may be that the bond market discounted the threat of future inflation because the Federal Reserve's policies are being viewed as effective, it may also be that market participants no longer believe that there will be fiscal or reform efforts that might be effective in pushing up growth and inflation for the foreseeable future. With the first six months of the Administration largely over and as mid-term elections draw closer, many investors have become increasingly doubtful of meaningful infrastructure spending or impactful reforms.

Our Performance: The Bloomberg Barclay's Intermediate Aggregate Bond Index returned 0.92% for the quarter. U.S. Treasuries posted a positive 0.66% on average while Agencies posted a 0.54% return. The investment grade corporate component returned 1.38%. Mortgage securities, too, outperformed, posting a 1.35% return. Outside of the Aggregate index, Municipal Bonds posted a 1.96% return while U.S. High Yield had a 1.98% return, continuing that sector's now quite elderly streak. (We believe valuations in that market are becoming stretched.) Finally, emerging market bonds (in U.S. dollars) rallied 1.38% continuing that sector's remarkable recovery after the volatility of 2016.

Our Taxable Active Fixed Income strategy outperformed the Barclay's Intermediate Aggregate Index by 45 bps during the second quarter with a return of 1.37% vs. 0.92%. The relative outperformance can largely be attributed to the performance of three credit focused funds (PTIAX (private mortgages +2.56%); PIGIX (corporates +2.94%); and GIBIX (asset backed securities +2.23%)). Our purchases of 5-year Treasury and Agency bonds when they hit a 2% yield also paid off as those maturities rallied significantly by the end of the quarter. These tactical trades and corresponding higher yield provided for overall outperformance in spite of our significantly lower duration profile which was a relative drag on performance in a falling rate environment. Assuming that the Fed maintains it current pace of one more rate hike this year (increasingly looking like a 50/50 proposition) and begins selling off its arsenal of bonds in the fourth quarter, we believe these new additions to the portfolio will perform well.

Our Expectations: We view the recent move down in long rates as not sustainable in the face of the Federal Reserve's pending bond sales, and so will keep our defensive duration posture. We have been underweight Mortgage Backed Securities (MBS) for quite some time, but are considering making further reductions in MBS positions given the supply that is expected out of the Fed later this year. We have also allowed a municipal bond to mature and placed the proceeds in a short duration fund while we look for opportunities elsewhere. Given the stress on Illinois and New Jersey, we fear that the Municipal market could see some weakness and are considering reducing positions there. Extended sectors, such as High Yield (see chart below) and Emerging Markets, appear to be largely overvalued at the present time.

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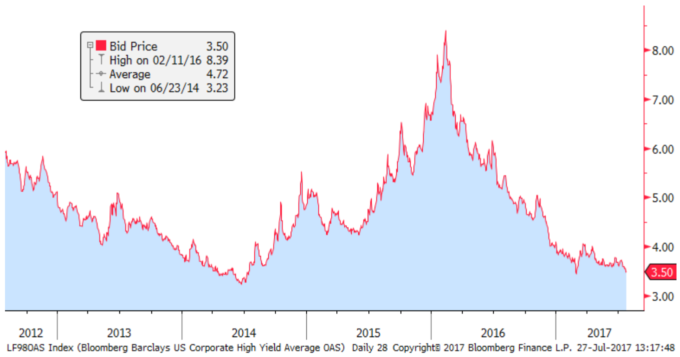
U.S. High Yield Market Spread over US Treasuries (%)



In spite of the recent bond purchases mentioned above, our duration positioning continues to be significantly shorter than the benchmark as we see the outlook on interest rates as asymmetrical. Overall interest rates are more likely to rise than fall given the general economic outlook and the outlook for Federal Reserve policy. We will maintain an overall defensive posture where duration positioning is concerned though we expect to continue to reduce our underweight in duration as interest rates rise and normalize, assuming that we can capture appropriate compensation in yield for doing so. This assumes that the yield curve steepens to a more normal shape. Should it remain flat, we will see no need to add duration unless signs of recession appear.

As always, stay tuned. We remain focused on executing our time-proven disciplines. As Clara Barton so wisely opined: "The surest test of discipline is its absence."

Nancy Tengler
Chief Investment Officer

Paul Dickson
Director of Fixed Income

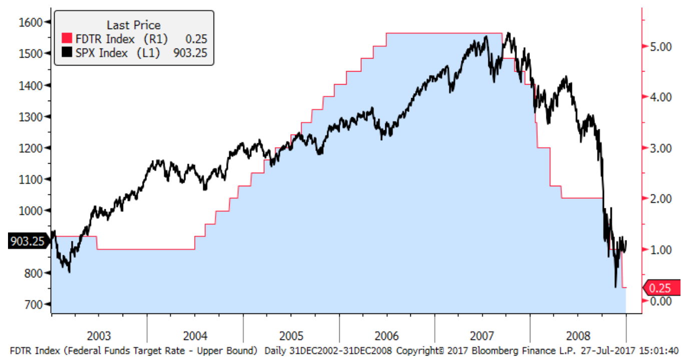
NB: FEDERAL RATES HIKES IN PERSPECTIVE

"It's appropriate for the Fed to gradually and cautiously increase our overnight interest rate over time."
– Janet Yellen

"Now I am become Death, the destroyer of worlds"
– Robert J. Oppenheimer

In conversations with colleagues and clients it is remarkable how few remember the last period of Federal Reserve monetary tightening. Questions such as "how quickly could the Fed raise rates?" and expressions of doubt that they might substantially do so demonstrate how accustomed everyone appears to have become to our low interest rate environment. Consider the chart below: In the mid-aughts the Fed raised the overnight Funds rate from 1% to 5.25% over a 2 year period by hiking rates at every single meeting by 25 bps.

Fed Funds Rate and the S&P Equity Index



Of course the economic environment that set off that round of monetary policy tightening was very different from that of today. Inflation (CPI) was running well above the Fed's target and peaked at 5.6% (Y/Y). Oil prices were surging, peaking at well over $140/bbl and the housing market had become a mania. The Federal Reserve's post dot-com loose monetary policy may well have been a principal culprit in the over-heating of the economy, so when they finally removed the proverbial "punchbowl" of low rates the party eventually ended. Undoubtedly the Fed did not expect a financial crisis would result in the wake of their bursting the housing bubble or they would not have had to cut rates so very quickly – and eventually to zero – in response.

In the current environment, with inflation running below the Fed's target of 2% (and receding) and growth muddling along, we do not expect any similar pace of tightening. In fact, in our estimation, the odds of an additional rate hike this year has fallen to near or below 50% as of this writing. The Fed is likely to first gauge how the first sales of their bond holdings (accumulated during three periods of Quantitative Easing) impact the market. Even that experiment might have to wait for Congress to approve a new debt ceiling and make further

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progress on the budget. Regardless, it is likely that over the coming year to 18 months, assuming the economy continues to recover, we will see resumption in Fed rate hikes. Do not discount the risk that - should the economy start to really find its groove (and who could have predicted the previous episode?) – the Fed might raise rates at a more robust pace. "History does not repeat itself, but it often rhymes."

HIGHLIGHTS | **2017 Q2 Review**

ECONOMY

- Through 06/30/2017 the S&P500 is up 9.34% and the current bull market is measured as the second longest on record.
  - History would argue this Bull could still have legs.
  - Naysayers opine that stock valuations have moved well ahead of earnings growth and that multiples are stretched.
- We would welcome a correction - not to be confused with a bear market. Corrections can:
  - Serve as a pruning mechanism to make way for new growth.
  - Provide opportunity for those that have been sitting on the sidelines to enter the game with fresh money.
  - Normalize valuations, which can provide a catalyst for further move up.
- Second quarter GDP just reported a positive 2.6%. The economy is chugging along in that not-too-hot-not-too-cold fashion that equity investors love.
- The Fed is being restrained by lower than expected inflation. Add a weak dollar and tame oil prices and we see an environment that is friendly to stocks.
- It should be noted that the U.S. has become the marginal producer of oil globally. Muted oil prices are here to stay in the medium term and that is good for the consumer, which is also good for economic growth.
- The consumer is in excellent shape, with debt well off 2008 levels. We are confident the consumer will remain healthy and spending.

BONDS

- In Q2 the fixed income markets were largely cam with a bias towards lower long-term rates as the market discounted both future inflation and the Fed's increasingly hawkish stance.
- The Fed action included a second short-term rate hike in June and the announcement of plans to begin selling off the bonds purchased during QE.
- Rates on the short end are anchored at or above the expected 1% beyond 3 months. Long-term rates are more of a puzzle.
  - Despite the Fed announcement, longer-term rates fell rather than taking the expected rise.
  - It may be that the bond market discounted the threat of future inflation.
- Our Taxable Active Fixed Income strategy outperformed its benchmark by 45bps during the second quarter.
  - Tactical trades provided overall outperformance in spite of our significantly lower duration profile.
- With the first six months of the Administration largely over, many investors have become doubtful of meaningful infrastructure spending or impactful reforms.

STOCKS

- Stocks logged in another strong performance during Q2.
- Earnings and revenue growth have pleasantly surprised to the upside YTD.
- Since the election, the market has been characterized by rotation from one sector to another.
- The sector market rotation has led investors to take advantage of attractive opportunities in underlying industries: first financials and then pharmaceuticals, biotech, aerospace and defense, internet software and services, and multi-line retail.

STRATEGIC ALLOCATION

- Heartland Financial, USA, Inc. and its member banks offer ten core investment strategies. YTD and in calendar year 2016, eight of our ten strategies outperformed their industry standard benchmarks.
- We generate excess total return over the long-term by employing a rigorous, time-proven investment valuation discipline that provide confidence to take appropriate action in difficult markets.
- We seek to buy companies with strong fundamentals at relatively attractive valuation levels.
- We continue to wait to see if this Administration can deliver tax reform or tax cuts before the end of the year. The market assumes not, so any movement would cause stocks to rally.
- Our international sub-advisor has produced outstanding performance since inception on February 1. We are pleased that our 15% allocation to international markets has delivered a premium to the market.
- In bonds, our duration positioning continues to be significantly shorter than the benchmark, as we see the outlook on interest rates as asymmetrical. We will maintain an overall defensive posture where duration positioning is concerned, though we expect to reduce our underweight in duration as interest rates normalize.